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FEATURES:

The False Promise of Public Pensions

By Frederick M. Hess and Juliet P. Squire

How do you pay those "defined" benefits?

In a memorable "Doonesbury" comic strip from the late 1970s, Garry Trudeau's Raoul Duke — serving as general manager of the Washington Redskins — improbably signed star free agent "Lava Lava" Lenny. When asked how he pulled off this remarkable feat, Duke insisted he had not spent "a penny more than he's worth! I swear it! Besides, the pension fund was just sitting there!"

In this punch line, Trudeau captured the tension that bedevils pensions — the incentive to focus on the here and now even if it holds the future hostage. Those temptations are rife when it comes to retirement systems in the private and public sectors. In the private sector, rules and regulations seek to tame corner-cutting and shortsighted behavior — with varying degrees of success. But for public pension funds the primary safeguard is the self-discipline of public officials and the hope that they will not be unduly tempted by short-term electoral considerations and influential constituencies.

Given the state of public pension funds, these safeguards hardly seem adequate. In 2008, the Pew Research Center projected that state pension plans are $731 billion short of meeting their $2.7 trillion obligation in coming decades. The 2008 and 2009 economic downturn has substantially aggravated that situation. Meanwhile, actuarial studies suggest contribution rates for public employees are lagging benefit cost, meaning the problem is due to get worse.

The vast majority of public employees — including teachers — are enrolled in defined-benefit pension plans. These plans are usually the product of state legislation that determines eligibility, benefit formulas, employer and employee contributions, and how payments will be calculated when an employee retires or leaves the system. Once an employee has become vested in a pension plan, they are guaranteed retirement income based on that formula.

Teacher pension systems pose two challenges for k–12 schooling. The first are the temptations of irresponsible fiscal stewardship. Pensions are in the business of delayed gratification, and public officials are not. Moreover, complex funding formulas mask the true costs. The second challenge is that pension arrangements hinder efforts to boost teacher quality by making it more difficult to attract talent in the contemporary labor market. Existing pension policies reduce worker flexibility and penalize teachers for moving across state lines, for departing before serving 25 or 30 years, and for remaining in the classroom after 30 years. This discourages potential entrants — including talented mid-career applicants — who might not be inclined to commit to a decades-long career in a single locale. In 2008, 30 states required an employee to work five years to become fully vested in the

typical public pension fund, and vesting in ten states required ten years of service.

Pension plans reflect an expectation that personnel will teach in the same state or district for the length of their career. This is no recipe for attracting college-educated talent in the 21st-century labor force. In the mid-20th century, the teaching force was dominated by women who often had few other options. Between 1965 and 2000, however, there was a 50 percent decline in the likelihood that a new female teacher ranked in the top ten percent on aptitude tests. A more flexible and portable model would ease exit from and reentrance into the profession and enable it to more effectively compete for talent.

Two models that offer more flexibility and portability than the predominant defined-benefit plans have become increasingly common in recent years: cash-balance plans and defined-contribution plans. Cash-balance plans have a guaranteed level of benefits, which accrue steadily and can be rolled over into an ira or another employer's retirement plan, should the employee change jobs. Defined-contribution plans, like 401(k)s, are even more portable and flexible.

In 1979, 62 percent of private-sector workers were enrolled in defined-benefit plans, compared to 16 percent in defined-contribution plans. By 2005, those numbers had reversed, with 63 percent of private-sector workers participating in defined-contribution plans and just 10 percent participating in defined-benefit plans. In other words, most employers are making it easier for workers to enter or exit jobs without putting retirement benefits at risk. The public sector, including teacher retirement plans, has not followed suit. While reform has the ability to help schools compete for teaching talent, the costs of reform are concentrated in an influential and active constituency. Today's career educators have contributed to the plans for years, understood their pension as a key element of their compensation, and traded opportunities they might have pursued in the private sector for the security implied by public employment. Meanwhile, the benefits of reform are dispersed among prospective teachers and among voters and parents, who have little cause to focus upon balance sheets or long-term implications for teacher quality.

The politics are predictable. Those who stand to lose from pension reform are typically far more energized, organized, and vocal than any of those who would benefit, making it unpopular and politically perilous for public officials to address funding shortfalls.

These political dynamics can flip when a fiscal crisis makes pension costs salient to the broader public and highlights how policymakers are compromising the public's interests in order to cater to public employees. Fiscal crisis and the alignment of the political stars have helped some states and localities to address the first challenge, yielding more sustainable benefit levels. However, reforms have done little to rationalize these systems for a changing labor market. Addressing the pension challenge is not merely a matter of technical patches; it is a question of politics.

Public pensions and government regulation

Pension funds are hardwired to the state political process by constitutional provisions, statutes, and collective bargaining agreements. The aarp reported in 2000 that 31 states have 93 constitutional provisions that secure the rights of beneficiaries.[1] All other states either have protections for pensions written into statute or recognized under common law. Crucially, when it comes to the policy implications, pension benefits are considered the property of beneficiaries. State legislatures can change the terms of benefits for new hires but have little ability to adjust benefits already promised. Ron Snell of the National Council of State Legislatures has explained, "Once granted, a pension is a contractual obligation of the employer, so that in most cases in most states it is impossible to cut the promise of a future benefit, or even to increase the employee contribution to the pension fund." This means that if investments perform poorly, the employer (i.e., taxpayers) must usually make up any

shortfall.

Investment decisions are typically entrusted to pension boards, which in turn hire actuaries to project the future costs of pension benefits and estimate the rate of return that the fund can expect. However, these estimates are widely recognized as malleable and board members have incentives to prefer actuaries and firms deemed to be team players. By manipulating actuarial assumptions, such as an expected rate of return, a fund can appear healthier than it would be if it used more conservative assumptions. Indeed, many fear that actuaries routinely underestimate the cost of public pensions by as much as a third.

Private pensions are required to comply with the Employee Retirement Income Security Act of 1974, which established minimum funding standards for company sponsored plans. However, there are few meaningful guardrails to prevent public officials from steering state pension systems into the ditch. As Deloitte Research has pointed out, “There are generally no requirements forcing public retirement plans to fund their pension liabilities. As a result these plans are funded to varying degrees, including some that are completely unfunded and operate on a ‘pay-as-you-go’ basis.” Public plans are governed by accounting standards set up by the Governmental Accounting Standards Board. These standards provide the framework for the annual audits that most governments contract to independent accounting firms, and those audit reports are a key factor in how credit risk agencies evaluate government credit quality. While gasb sets guidelines, however, it has little or no enforcement power and limited incentive to confront the states and localities that contribute to its budget. Intended safeguards like independent actuaries too often provide a flimsy bulwark against chicanery or political irresponsibility.

Pensions and public employee unions

Two dynamics dominate the politics of public pensions. The first, and most obvious, is that those who are in line for pensions are intensely interested in the contributions they are asked to make, the age at which they become eligible for benefits, and the size of the benefit they will receive — aware that modest tweaks to pension rules could be worth tens or hundreds of thousands of dollars to them personally. Those who do not stand to benefit — meaning everyone in the state or community who is not a public employee — have little at stake. Even substantial changes to pension systems will not have more than a glancing impact on any individual taxpayer. Consequently, public officials are presented with an active, organized, and influential constituency demanding generous benefits and opposition that is restricted to anti-tax activists or budget watchdogs that lack the votes, network, and resources of the public employee unions.

The second dynamic is the inevitable tension between younger public employees and their veteran colleagues. Veteran employees are deeply invested in promised benefits and regard any effort to alter those benefits as an attempt to renege on a promise. Newer employees have much less at stake. They are much further from collecting benefits, have put little into the system, and consequently face much smaller opportunity costs should those plans be altered. Moreover, newer teachers are by and large younger and more attuned to a highly mobile job market than are teachers who entered the workforce two decades ago.

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The split between newer teachers and their veteran colleagues shows up clearly, to take one example, in a 2008 Education Sector national survey of teachers. Twenty-six percent of recent hires think that the unions “lean more toward taking care of the needs of veteran teachers” and just four percent think that they favor newer teachers. New teachers are also more likely to favor reforming traditional pay systems than are veteran teachers. In the spring of 2006, University of Washington

researchers Dan Goldhaber and Michael DeArmond surveyed Washington state teachers and found that "all else equal, teachers newer to the profession are far more likely to be favorably inclined toward a defined contribution system than the more traditional defined benefit system."

The ranks of union leaders are dominated by longtime educators. Given that approximately half of new teachers exit the profession within five years and that the process of establishing rank-and-file credibility within a union typically takes years and requires extended service in a variety of lesser posts, this is no surprise. Union leaders in any sector place a premium on maintaining solidarity and unity — prompting them to prefer uniform collective benefit systems and to be disinclined to accept measures which differentiate employees or create individualized accounts. Given that schools will not shutter due to international competition, teacher unions have little cause to fear that generous benefits will reduce the number of available jobs. Indeed, efforts to reduce class size have led to a 51 percent increase in the teacher workforce since 1980, creating more than a million new teaching jobs even as teacher benefits have expanded.

Except in the most extraordinary crises, the steadfast opposition of National Education Association (nea) and American Federation of Teachers (aft) affiliates and fellow employee unions to measures that would scale back benefits, increase employee contributions, or make the existing system more attractive to younger employees has stifled serious proposals to alter pension rules. Indeed, while some observers have been trumpeting the need to overhaul teacher pensions since the 1970s, just 11 states and the District of Columbia have adopted any kind of defined-contribution alternatives and just four of these have defined-contribution plans as their primary plans.

The source of teacher union influence on pensions also lies in their numbers, resources, and organization.

The source of teacher union influence on pensions also lies in their numbers, resources, and organization. While general union membership in the U.S. has steadily declined in recent decades, from 24 percent of all public and private employees in 1973 to 12 percent in 2006, union membership among public sector employees grew from 23 percent in 1973 to 36 percent in 2006. With more than 80 percent of the nation's teachers in a union, teaching is the most highly unionized profession in America. Including teachers and other employees in allied "education, training, and library occupations," the nea represents a total of 3.2 million members and the aft1.4 million (most, but not all, of them are teachers). Surveying political contributions from 1989 to 2008, the nonpartisan Center for Responsive Politics named the nea and aft as two of the nation's 20 "most influential organizations in federal politics," with the nea ranked seventh and the aft15th.

It would be a mistake, however, to think the strength of the nea or the aft primarily lies in Washington. Most observers regard the unions as strongest at the state and local level where 90 percent of education spending takes place. Terry Moe has written that, in state legislatures, "The teacher unions are aggressive, omnipresent participants . . . [they] are the 500-pound gorillas of legislative politics."

Union clout was famously displayed in California in January 2005, when Governor Arnold Schwarzenegger proposed converting public pensions in California from defined-benefit plans to 401 (k)-style defined-contribution plans. He explained that California had promised "state workers more than it should and more than it could," noting that pension obligations had grown from $160 million in 2000 to $2.6 billion in 2005. Schwarzenegger proposed that pensions for new state workers reflect those for workers without government jobs. The proposed reforms drew immediate criticism from California's public employee unions. Within weeks of Schwarzenegger's announcement, the California School Employees Association boasted that 20 unions representing 2.5 million members had already formed a "pension protection coalition." The union message was carried forth by sympathetic figures like teachers, nurses, firefighters, widows, and orphans who portrayed

Schwarzenegger as cruel and out of touch. By spring, the Los Angeles Times observed, “In just a few months, Schwarzenegger has gone from seeming invincibility to a politically precarious state, his approval ratings sagging and his staff plagued by internal scuffles.” Schwarzenegger abandoned the proposal in April that year.

A familiar story: Crisis, then reform

It is useful to see how these pressures can play out, encouraging gradually expanding promises and spurring public officials to hope that market gains or financial sleight-of-hand can spare them from making unpleasant choices. The New Jersey experience illustrates that it is only when the gloom of crisis finally descends that public officials muster the will to address the mismatch between promises and resources. And even then, the measures tend to be grudging and makeshift.

In 1997, Governor Christine Whitman issued $3.4 billion in pension obligation bonds — essentially borrowing dollars to inject immediately into the pension fund by taking on new long-term obligations. The maneuver allowed Whitman to forgo the state’s annual contribution to the pension fund and use those dollars to avoid spending cuts or tax increases in an election year, a bad deal that was possible only because the state projected an optimistic 12 percent annual return on its investments.

In 1990, a majority of the state’s retirement plan assets had been in safe, low-yield, fixed-income accounts. By 2000, Whitman’s 12 percent goal meant that about 70 percent were invested in equities. The 1990s stock market boom led to an initial surplus, prompting state and local government employees to push for a benefit boost in 2000 — the last year of the dot-com boom. Acting Governor Donald T. DiFrancesco, a Republican, said, “The way I look at it, if the pension system is healthy, if we can give them some benefit resulting from the good economy, I say give it to them.” In 2001, in the midst of a heated election season, the legislature voted to enhance pension benefits by nine percent, committing $4 billion of the surplus accumulated during the boom years. Even though the state’s pension funds lost $12.5 billion between June 2000 and March 2001 — the entire surplus on which the legislature and pension board were counting — DiFrancesco signed the increased benefits into law in June 2001.

In 2002, newly elected Governor James McGreevey proposed an early retirement plan in order to reduce budget outlays. Similar efforts by Governor Jim Florio in 1992 and 1994 had led to short-term budget savings but had significantly increased long-term pension costs. The bill was nonetheless signed into law on May 31, with Treasury officials conceding the program would cost the state $220 million over five years. By 2003, the state’s once flush pension system was among the worst performing in the nation. Local municipalities had to raise taxes to make their contributions to the state pension funds in 2004. The East Brunswick Finance Director said, “Everyone knew this holiday was coming to an end” and termed the suspension of state payments in 1997 “a classic example of sacrificing the future on the altar of the immediate.” Meanwhile, the McGreevey administration failed to inject the $400 million in 2003 that it was required by law to provide, with the state treasurer explaining the state couldn’t “afford to make the contribution.”

Teachers unions blamed the state for failing to make required contributions. Lawmakers blamed the investment board for underperformance and called for investments in high-yield bonds and real estate (the investments that were doing well in the aftermath of the dot-com crash). Meanwhile, Governor McGreevey did not direct any money into the pension fund again in 2004, despite the actuary’s recommendation that a $1 billion infusion was needed. After McGreevey resigned amidst an unrelated 2004 scandal, Acting Governor Richard Codey announced that he would not seek election and pledged to veto any legislation that would enhance retirement benefits without paying for them. It was no surprise when the pension crisis emerged as a key issue of the 2005 gubernatorial race. Four union political action committees, including the New Jersey State Laborers pac and the New Jersey Education Association (njea) pac, were among the top 10 givers in that

year's campaign. Democratic nominee Jon Corzine, a former Goldman Sachs executive and U.S. senator, won the election.

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After his January 2006 inauguration, Governor Corzine set to work on rehabilitating the state's pension funds. "Make no mistake — our unfunded pension obligation is a real bill," Corzine told lawmakers. Corzine's proposed $1.5 billion contribution exceeded the total payments governors made to the retirement funds over the preceding nine years, but it amounted to just 70 percent of the amount actuaries deemed necessary.

Corzine convened a special session to examine public worker benefits and cut property taxes, urging legislators to find ways to reduce pension costs. Proposals included raising the retirement age to 62, adding co-payments for health coverage, and rolling back pension benefits by about 9 percent for new employees. Employee unions launched a fierce counterattack, saying that they supported proposals to curtail pension abuses but regarded "any reduction in rank-and-file pensions . . . to be a nonstarter." Corzine responded by agreeing to negotiate with the unions at the collective bargaining table.

He claimed some modest concessions from public workers' unions in the ensuing agreement, exchanging 3 to 3.5 percent raises over the following four years for a 1.5 percent contribution to health care costs, an increase in the retirement age for new workers from 55 to 60, and a cap on pension payments for some highly paid employees. Returns would be worth close to $1 billion. The various unions approved the contract a few months later. "This is a guy [Corzine] who stood up for organizing rights at Rutgers University; who spoke at our rally last summer; who made contributions to our pension for the first time in ten years," said Bob Master, lead negotiator for the Communication Workers of America (cwa).

In light of the fact that lawmakers had boosted pensions 17 times since 1999, Master acknowledged that unions were fortunate to receive 13 percent in salary increases spread over four years and retain fringe benefits "essentially intact."

The future of pension politics

Reforming public pensions is as much a political exercise as a fiscal one. Addressing persistent underfunding or structural incentives requires far more than technical analysis — it requires fostering awareness and building support for change, and changing the political climate by altering political incentives or designing politically workable solutions. For one thing, existing safeguards, such as independent pension boards and actuarial expertise, too often prove a frail bulwark against irresponsibility. For another, even when public officials have enjoyed some success in confronting pension problems, they have focused almost exclusively on budgetary shortfalls. They have not reworked retirement systems to make teaching more competitive with other professions in the contemporary labor market. Successful reform must begin by recognizing that the system of teacher training, hiring, staffing, and compensation that worked passably well in the 1950s is no longer well-suited to labor market realities today.

Public pension politics are characterized by four simple truths. First, elected officials are incentivized to emphasize the short-term; this dictates a need to create institutions and rules that ameliorate that temptation. Second, meaningful reform is only possible when the broad public is motivated to counter the influence of employee unions. Third, legislators and governors rarely accept responsibility for poor stewardship or extravagant promises, often shifting blame to pension managers and

investments for shortfalls. Finally, modifying pension systems requires addressing concerns of veterans who will feel cheated out of what they have been promised.

Given the political landscape, there are at least three tacks that pension reformers might take. The first is to embrace a “starve-the-beast” strategy. Legislators are tempted — and encouraged by unions — to direct any available dollars toward expanded benefits, implying that funding shortfalls may impose a perverse discipline. In other words, the fiscally responsible course of maintaining healthy reserves can invite political irresponsibility. Of course, even when public officials finally bite the bullet on the mismatch between promises and resources, there is little evidence that they will have the stomach to address anachronistic pension rules that push out capable veterans at age 55 or keep worn-out teachers in the classroom for years past their prime. Why? Because while there may be bondholders or voters who are attentive to untenable shortfalls, none are attuned to how the state responds to labor market dynamics.

Second, reform proponents can change the context of the political debate by framing debates over policy and practice in terms of the costs of current arrangements. This is extraordinarily difficult to do, however, and the reality is that it only happens when fiscal crisis throws policy choices into stark relief. When those moments emerge, reform-minded legislators and advocates have the opportunity to harness public opinion and frame benefit increases as irresponsible kowtowing to “special interests.” The effort to manufacture such a moment can fall flat — as happened with Schwarzenegger’s effort in California — which is why reformers must use fiscal crises as opportunities to modernize benefits and promote responsible fiscal stewardship, and not simply settle for makeshift patches.

There are institutional innovations that can better enable public officials to make the difficult choices on pension reform.

The rewards for public officials are almost nonexistent; as Scott Porter noted of Corzine’s efforts in New Jersey, “Twenty years from now, then you’d start to see some [of the fruits] of this.” Given that the rewards for pension reform are so out of step with political incentives, it is essential to devise institutions and arrangements that don’t depend on self-abnegating public officials for responsible stewardship. For example, H. Ross Perot’s 1992 bid for the U.S. presidency led to extraordinary attention to the federal budget deficit, which in turn led to the adoption of new budget rules in Congress and to budget surpluses in the closing years of that decade.

Finally, and perhaps most significantly, there are institutional innovations that can better enable public officials to make these difficult choices. This might include increasing the autonomy and independence of auditors and providing greater insulation from pension boards and legislators or creating a federal or multistate body with the authority to police public pensions and establish guidelines regarding fund balances and anticipated rates of return. Adopting such measures would be enormously difficult, but they need only to be adopted once. Afterwards, legislators would operate with more barriers against irresponsible behavior, making it easier to explain “no” votes to interested constituencies and harder for officials to make unaffordable promises in the future. Using windows of opportunity to enact such measures doesn’t just address the current problem but alters the political calculus going forward.

An example worth emulating is how Georgia draws attention to the fiscal impact of new promises and prevents unfunded commitments. In 1983, Georgia enacted the Retirement Systems Standards Law requiring any legislation with a fiscal impact on the state pension plan to be subject to additional independent and legislative scrutiny. To be considered by the legislature, a measure must first be sent to the Office of Legislative Counsel. If the Legislative Counsel finds that the law has a fiscal impact on the retirement system, it cannot be enacted unless it is concurrently funded. A bill may be passed, but if it is deemed by the state auditor to be unfunded, the law is “null and void and shall

stand repealed." Given that Georgia's state auditor is appointed by the governor, the safeguard is far from ironclad. Nonetheless, this kind of insulation and analysis provides a "cooling off" period to ensure that the costs and implications are fully aired.

Another example is represented by the U.S. Congress's highly successful Defense Base Closure and Realignment Commission (brac), which succeeded in closing more than 350 military installations through a process designed to counter the tendency for legislators to advocate modernization while bitterly resisting any effort to shutter a hometown base. Legislators, historically, embrace cost savings in theory but face enormous pressure to protect hometown jobs. The brac process established criteria for base closures on the front end and then required legislators to vote the entire proposed package up or down. This meant that officials could no longer lobby to protect particular bases, providing substantial insulation against irate constituents and framing a vote to reject closures as a vote for wasteful spending.

Legislators find it enormously difficult to resist the pressure of public employee groups, which fear that even changes which "grandfather" current employees may sow future splits within union ranks. Devising policy proposals that allow legislators to more readily argue they are voting for a package of provisions to help attract quality teachers rather than to take away benefits could allow reformers to embrace tough change by making a "no" vote look like a capitulation to narrow interests. None of this should be taken to suggest that such a path is easy, only that such approaches offer a more fruitful course than those tried to date.

The temptation for politicians to see pension funds as just "sitting there" is profound, and Raoul Duke's jaunty solution — to "charge a little more for hot dogs this year" — will rarely suffice. Indeed, even the three courses of action just discussed offer little to spur a shift from defined-benefit plans or revisit the industrial-era pension model. The stars are more likely to align for responsible fiscal stewardship than for labor policy modernization — and the case for optimism on the first count itself is far from rosy. Only time will ultimately tell whether looming fiscal crises and unaffordable promises will yield a new era in which the electoral rewards for fiscal responsibility and workforce modernization rival those of impassioned claimants.

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